

HERSHEY CO
Form 10-Q
August 08, 2007

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

- ☒ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended **July 1, 2007**

OR

- ☐ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934

For the transition period
from _____ to _____

Commission file number 1-183

THE HERSHEY COMPANY

100 Crystal A Drive
Hershey, PA 17033

Registrant's telephone number: **717-534-4200**

State of Incorporation
Delaware

IRS Employer Identification No.
23-0691590

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Large accelerated filer ☒ Accelerated filer ☐ Non-accelerated filer ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ☐ No ☒

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Common Stock, \$1 par value – 167,243,374 shares, as of July 20, 2007. Class B Common Stock, \$1 par value – 60,815,010 shares, as of July 20, 2007.

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PART I - FINANCIAL INFORMATION**Item 1. Consolidated Financial Statements (Unaudited)**

THE HERSHEY COMPANY
CONSOLIDATED STATEMENTS OF INCOME
(in thousands except per share amounts)

	For the Three Months Ended	
	July 1, 2007	July 2, 2006
Net Sales	\$ 1,051,916	\$ 1,051,912
Costs and Expenses:		
Cost of sales	722,478	644,077
Selling, marketing and administrative	216,870	221,478
Business realignment charge, net	79,728	4,240
Total costs and expenses	1,019,076	869,795
Income before Interest and Income Taxes	32,840	182,117
Interest expense, net	29,213	27,490
Income before Income Taxes	3,627	154,627
Provision for income taxes	73	56,730
Net Income	\$ 3,554	\$ 97,897
Earnings Per Share - Basic - Class B Common Stock	\$.01	\$.38
Earnings Per Share - Diluted - Class B Common Stock	\$.02	\$.38
Earnings Per Share - Basic - Common Stock	\$.02	\$.42
Earnings Per Share - Diluted - Common Stock	\$.01	\$.41
Average Shares Outstanding - Basic - Common Stock	168,309	175,779
Average Shares Outstanding - Basic - Class B Common Stock	60,815	60,817
Average Shares Outstanding - Diluted	231,963	240,124
Cash Dividends Paid per Share:		
Common Stock	\$.2700	\$.2450
Class B Common Stock	\$.2425	\$.2200

The accompanying notes are an integral part of these consolidated financial statements.

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THE HERSHEY COMPANY
CONSOLIDATED STATEMENTS OF INCOME
(in thousands except per share amounts)

	For the Six Months Ended	
	July 1, 2007	July 2, 2006
Net Sales	\$ 2,205,025	\$ 2,191,419
Costs and Expenses:		
Cost of sales	1,461,556	1,351,442
Selling, marketing and administrative	433,303	438,272
Business realignment charge, net	107,273	7,571
Total costs and expenses	2,002,132	1,797,285
Income before Interest and Income Taxes	202,893	394,134
Interest expense, net	57,468	52,693
Income before Income Taxes	145,425	341,441
Provision for income taxes	48,398	121,073
Net Income	\$ 97,027	\$ 220,368
Earnings Per Share - Basic - Class B Common Stock	\$.39	\$.86
Earnings Per Share - Diluted - Class B Common Stock	\$.39	\$.85
Earnings Per Share - Basic - Common Stock	\$.43	\$.95
Earnings Per Share - Diluted - Common Stock	\$.42	\$.91
Average Shares Outstanding - Basic - Common Stock	169,078	174,344
Average Shares Outstanding - Basic - Class B Common Stock	60,815	60,818
Average Shares Outstanding - Diluted	232,841	241,644
Cash Dividends Paid per Share:		
Common Stock	\$.5400	\$.4900
Class B Common Stock	\$.4850	\$.4400

The accompanying notes are an integral part of these consolidated financial statements.

THE HERSHEY COMPANY
CONSOLIDATED BALANCE SHEETS
(in thousands of dollars)

ASSETS	July 1, 2007	December 31, 2006
Current Assets:		
Cash and cash equivalents	\$ 38,822	\$ 97,141
Accounts receivable - trade	378,178	522,673
Inventories	813,836	648,820
Deferred income taxes	55,976	61,360
Prepaid expenses and other	138,828	87,818
Total current assets	1,425,640	1,417,812
Property, Plant and Equipment, at cost	3,689,031	3,597,756
Less-accumulated depreciation and amortization	(2,100,868)	(1,946,456)
Net property, plant and equipment	1,588,163	1,651,300
Goodwill	508,849	501,955
Other Intangibles	234,549	140,314
Other Assets	510,035	446,184
Total assets	\$ 4,267,236	\$ 4,157,565
 LIABILITIES, MINORITY INTEREST AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	\$ 248,099	\$ 155,517
Accrued liabilities	426,873	454,023
Accrued income taxes	56	—
Short-term debt	926,262	655,233
Current portion of long-term debt	14,669	188,765
Total current liabilities	1,615,959	1,453,538
Long-term Debt	1,272,504	1,248,128
Other Long-term Liabilities	590,144	486,473
Deferred Income Taxes	200,950	286,003
Total liabilities	3,679,557	3,474,142
Minority Interest	16,378	—
Stockholders' Equity:		
Preferred Stock, shares issued: none in 2007 and 2006	—	—
Common Stock, shares issued: 299,086,734 in 2007 and 299,085,666 in 2006	299,086	299,085
Class B Common Stock, shares issued: 60,815,010 in 2007 and 60,816,078 in 2006	60,815	60,816
Additional paid-in capital	324,043	298,243
Retained earnings	3,941,644	3,965,415
Treasury-Common Stock shares at cost: 131,858,178 in 2007 and 129,638,183 in 2006	(3,951,479)	(3,801,947)
Accumulated other comprehensive loss	(102,808)	(138,189)

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Total stockholders' equity	571,301	683,423
Total liabilities, minority interest, and stockholders' equity	\$ 4,267,236	\$ 4,157,565

The accompanying notes are an integral part of these consolidated balance sheets.

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THE HERSHEY COMPANY
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands of dollars)

	For the Six Months Ended	
	July 1, 2007	July 2, 2006
Cash Flows Provided from (Used by) Operating Activities		
Net Income	\$ 97,027	\$ 220,368
Adjustments to Reconcile Net Income to Net Cash Provided from Operations:		
Depreciation and amortization	144,003	98,059
Stock-based compensation expense, net of tax of \$4,377 and \$10,131, respectively	7,988	18,487
Excess tax benefits from exercise of stock options	(8,481)	(3,529)
Deferred income taxes	41,069	6,704
Business realignment initiatives, net of tax of \$61,342 and \$1,347, respectively	103,430	3,025
Contributions to pension plans	(7,836)	(8,592)
Changes in assets and liabilities, net of effects from business acquisitions:		
Accounts receivable - trade	149,719	180,188
Inventories	(166,637)	(243,715)
Accounts payable	87,044	(11,389)
Other assets and liabilities	(153,821)	(92,255)
Net Cash Flows Provided from Operating Activities	293,505	167,351
Cash Flows Provided from (Used by) Investing Activities		
Capital additions	(77,905)	(80,233)
Capitalized software additions	(5,259)	(7,104)
Business acquisitions	(76,989)	—
Net Cash Flows (Used by) Investing Activities	(160,153)	(87,337)
Cash Flows Provided from (Used by) Financing Activities		
Net increase in short-term debt	264,231	315,268
Repayment of long-term debt	(188,800)	(117)
Cash dividends paid	(120,798)	(113,168)
Exercise of stock options	42,234	17,394
Excess tax benefits from exercise of stock options	8,481	3,529
Repurchase of Common Stock	(197,019)	(346,618)
Net Cash Flows (Used by) Financing Activities	(191,671)	(123,712)
Decrease in Cash and Cash Equivalents	(58,319)	(43,698)
Cash and Cash Equivalents, beginning of period	97,141	67,183
Cash and Cash Equivalents, end of period	\$ 38,822	\$ 23,485
Interest Paid	\$ 62,495	\$ 51,677

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Income Taxes Paid	\$	105,852	\$	154,243
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The accompanying notes are an integral part of these consolidated financial statements.

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THE HERSHEY COMPANY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. BASIS OF PRESENTATION

Our unaudited consolidated financial statements provided in this report include the accounts of the Company and our majority-owned subsidiaries and entities in which we have a controlling financial interest after the elimination of intercompany accounts and transactions. We prepared these statements in accordance with the instructions to Form 10-Q. These statements do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements.

We included all adjustments (consisting only of normal recurring accruals) which we believe were considered necessary for a fair presentation. We reclassified certain prior year amounts to conform to the 2007 presentation. Operating results for the six months ended July 1, 2007 may not be indicative of the results that may be expected for the year ending December 31, 2007, because of the seasonal effects of our business.

Items Affecting Comparability

Securities and Exchange Commission Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Misstatements When Quantifying Misstatements in Current Year Financial Statements* ("SAB No. 108"), required companies to change the accounting principle used for evaluating the effect of possible prior year misstatements when quantifying misstatements in current year financial statements. As a result, at December 31, 2006 we changed one of the five criteria of our revenue recognition policy, resulting in a delay in the recognition of revenue on goods in-transit until they are received by our customers. As permitted by SAB No. 108, we adjusted our financial statements for the three-month and six-month periods ended July 2, 2006 to provide comparability. These adjustments were not material to our results of operations for those periods. For more information, refer to the consolidated financial statements and notes included in our 2006 Annual Report on Form 10-K.

2. BUSINESS ACQUISITIONS

In May 2007, our Company and Godrej Beverages and Foods, Ltd., one of India's largest consumer goods, confectionery and food companies, entered into an agreement to manufacture and distribute confectionery products, snacks and beverages across India. Under the agreement, we invested \$58.7 million during the second quarter and own a 51% controlling interest. Total liabilities assumed were \$59.0 million. Effective in May 2007, this business acquisition was included in our consolidated results.

Also in May 2007, our Company and Lotte Confectionery Co., LTD., entered into a manufacturing agreement in China that will produce Hershey products and certain Lotte products for the market in China. We invested \$18.3 million in the second quarter of 2007 and own a 44% interest. We will account for this investment under the equity method.

Under each of the acquisition agreements, our Company and the other parties are currently obligated to make additional investments. We expect to invest a total of approximately \$23.8 million later this year in these businesses. The additional investments will not change our ownership interests.

3. STOCK COMPENSATION PLANS

At our annual meeting of stockholders, held April 17, 2007, stockholders approved The Hershey Company Equity and Incentive Compensation Plan ("EICP"). The EICP is an amendment and restatement of our former Key Employee Incentive Plan, a share-based employee incentive compensation plan, and is also a continuation of our Broad Based Stock Option Plan, Broad Based Annual Incentive Plan and Directors' Compensation Plan. Following its adoption on April 17, 2007, the EICP became the single plan under which grants using shares for compensation and incentive purposes will be made. The following table summarizes our stock compensation costs:

	For the Three Months Ended		For the Six Months Ended	
	July 1, 2007	July 2, 2006	July 1, 2007	July 2, 2006
	(in millions of dollars)			
Total compensation amount charged against income for stock compensation plans, including stock options, performance stock units ("PSUs") and restricted stock units	\$ 5.5	\$15.5	\$12.4	\$ 29.5
Total income tax benefit recognized in Consolidated Statements of Income for share-based compensation	\$ 1.9	\$ 5.7	\$ 4.4	\$ 10.5

The decrease in share-based compensation expense from 2006 to 2007 was primarily associated with lower performance expectations for the PSUs and the timing of stock option grants in 2007. The 2007 stock option grants were delayed pending approval by our stockholders of the EICP at the annual meeting in April 2007.

We estimated the fair value of each stock option grant on the date of the grant using a Black-Scholes option-pricing model and the weighted-average assumptions set forth in the following table:

	For the Six Months Ended	
	July 1, 2007	July 2, 2006
Dividend yields	2.0%	1.6%
Expected volatility	19.5%	23.7%
Risk-free interest rates	4.6%	4.6%
Expected lives in years	6.6	6.6

Stock Options

A summary of the status of our stock options as of July 1, 2007, and the change during 2007 is presented below:

	For the Six Months Ended July 1, 2007		
Stock Options	Shares	Weighted-Average	Weighted-Average Remaining

		Exercise Price	Contractual Term
Outstanding at beginning of the period	13,855,113	\$40.29	6.3 years
Granted	2,000,325	\$54.63	
Exercised	(1,268,528)	\$29.61	
Forfeited	(127,990)	\$54.96	
Outstanding as of July 1, 2007	14,458,920	\$43.08	6.5 years
Options exercisable as of July 1, 2007	8,691,849	\$37.11	5.3 years

	For the Six Months Ended	
	July 1, 2007	July 2, 2006
Weighted fair value of options granted (per share)	\$ 12.95	\$ 15.06
Intrinsic value of options exercised (in millions of dollars)	\$ 31.3	\$ 13.5

- As of July 1, 2007, the aggregate intrinsic value of options outstanding was \$140.1 million and the aggregate intrinsic value of options exercisable was \$129.2 million.
- As of July 1, 2007, there was \$52.1 million of total unrecognized compensation cost related to non-vested stock option compensation arrangements granted under our stock option plans. That cost is expected to be recognized over a weighted-average period of 2.7 years.

Performance Stock Units and Restricted Stock Units

A summary of the status of our performance stock units and restricted stock units as of July 1, 2007, and the change during 2007 is presented below:

	For the Six Months Ended July 1, 2007	Weighted-average grant date fair value for equity awards or market value for liability awards
Performance Stock Units and Restricted Stock Units		
Outstanding at beginning of year	1,075,748	\$44.89
Granted	273,572	\$51.50
Performance assumption change	(145,533)	\$53.49
Vested	(414,728)	\$49.08
Forfeited	(350)	\$49.80
Outstanding as of July 1, 2007	788,709	\$42.54

As of July 1, 2007, there was \$16.5 million of unrecognized compensation cost relating to non-vested performance stock units and restricted stock units. We expect to recognize that cost over a weighted-average period of 2.6 years.

	For the Six Months Ended	
	July 1, 2007	July 2, 2006
Intrinsic value of share-based liabilities paid, combined with the fair value of shares vested (in millions of dollars)	\$ 21.0	\$ 3.7

The lower amount in 2006 was primarily associated with the additional three-year vesting term for performance stock unit grants for the 2003-2005 performance cycle ("2003 grants") which reduced the number of shares that vested in 2006 compared with 2007. An additional three-year vesting term was imposed on the grant date for the 2003 grants with

accelerated vesting for retirement, disability or death. The compensation cost based on grant date fair value for the 2003 grants is being recognized over a period from three to six years.

Deferred performance stock units, deferred restricted stock units, and directors' fees and accumulated dividend amounts representing deferred stock units totaled 725,705 units as of July 1, 2007. Each unit is equivalent to one share of the Company's Common Stock.

No stock appreciation rights were outstanding as of July 1, 2007.

For more information on our stock compensation plans, refer to the consolidated financial statements and notes included in our 2006 Annual Report on Form 10-K and our proxy statement for the 2007 annual meeting of stockholders.

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4. INTEREST EXPENSE

Net interest expense consisted of the following:

	For the Six Months Ended	
	July 1, 2007	July 2, 2006
	(in thousands of dollars)	
Interest expense	\$ 58,860	\$ 53,531
Interest income	(1,327)	(817)
Capitalized interest	(65)	(21)
Interest expense, net	\$ 57,468	\$ 52,693

For the first six months of 2007, net interest expense was higher than the comparable period of 2006, primarily due to the financing of share repurchases. Higher interest rates in 2007 as compared with 2006 also contributed to the increase in net interest expense.

5. BUSINESS REALIGNMENT INITIATIVES

In February 2007, we announced a comprehensive, three-year supply chain transformation program (the “2007 business realignment initiatives”). When completed, this program will greatly enhance our manufacturing, sourcing and customer service capabilities, reduce inventories resulting in improvements in working capital and generate significant resources to invest in our growth initiatives. These initiatives include accelerated marketplace momentum within our core U.S. business, creation of innovative new product platforms to meet customer needs and disciplined global expansion. Under the program, which will be implemented in stages over the next three years, we will significantly increase manufacturing capacity utilization by reducing the number of production lines by more than one-third, outsource production of low value-added items and construct a flexible, cost-effective production facility in Monterrey, Mexico to meet current and emerging marketplace needs. The program will result in a total net reduction of 1,500 positions across our supply chain over the next three years.

The estimated pre-tax cost of the program is from \$525 million to \$575 million over the next three years. The total includes from \$475 million to \$525 million in business realignment costs and approximately \$50 million in project implementation costs. The costs will be incurred primarily in 2007 and 2008, with approximately \$270 million to \$300 million expected in 2007.

In July 2005, we announced initiatives intended to advance our value-enhancing strategy (the “2005 business realignment initiatives”). Charges for the 2005 business realignment initiatives were recorded during 2005 and 2006 and the 2005 business realignment initiatives were completed by December 31, 2006.

Charges (credits) associated with business realignment initiatives recorded during the three-month and six-month periods ended July 1, 2007 and July 2, 2006 were as follows:

	For the Three Months Ended		For the Six Months Ended	
	July 1, 2007	July 2, 2006	July 1, 2007	July 2, 2006
	(in thousands of dollars)			
Cost of sales				
2007 business realignment initiatives	\$ 41,307	\$ —	\$ 51,166	\$ —
2005 business realignment initiatives	—	—	—	(1,599)
Previous business realignment initiatives	—	(1,600)	—	(1,600)
Total cost of sales	41,307	(1,600)	51,166	(3,199)
Selling, marketing and administrative				
2007 business realignment initiatives	3,347	—	6,333	—
Business realignment and asset impairments, net				
2007 business realignment initiatives:				
Fixed asset impairments and plant closure expenses	13,878	—	40,098	—
Employee separation costs	51,534	—	52,859	—
Contract termination costs	14,316	—	14,316	—
2005 business realignment initiatives	—	3,727	—	7,058
Previous business realignment initiatives	—	513	—	513
Total business realignment and asset impairments, net	79,728	4,240	107,273	7,571
Total net charges associated with business realignment initiatives	\$ 124,382	\$ 2,640	\$ 164,772	\$ 4,372

The charge of \$41.3 million recorded in cost of sales during the second quarter of 2007 for the 2007 business realignment initiatives related to the accelerated depreciation of fixed assets over a reduced estimated remaining useful life and costs related to inventory reductions. The \$3.3 million recorded in selling, marketing and administrative expenses related primarily to project administration. In determining the costs related to fixed asset impairments, fair value was estimated based on the expected sales proceeds. Certain real estate with a net realizable value of \$5.4 million was being held for sale as of July 1, 2007. The employee separation costs included \$22.3 million for involuntary terminations at six North American manufacturing facilities which are being closed. The facilities are located in Naugatuck, Connecticut; Reading, Pennsylvania; Oakdale, California; Smiths Falls, Ontario; Montreal, Quebec; and Dartmouth, Nova Scotia. The employee separation costs also included \$29.2 million for charges relating to pension and other post-retirement benefits curtailments and special termination benefits.

Charges (credits) associated with previous business realignment initiatives which began in 2003 and 2001 resulted from the finalization of the sale of certain properties, adjustments to liabilities which had previously been recorded, and the impact of the settlement as to several of the eight former employees who had filed a complaint alleging that the Company had discriminated against them on the basis of age in connection with the 2003 business realignment

initiatives. The \$3.7 million charge associated with the 2005 business realignment initiatives was related primarily to the U.S. Voluntary Workforce Reduction Program (“VWRP”), in addition to costs for streamlining the Company’s international operations and facility rationalization relating to the closure of the Las Piedras, Puerto Rico plant. The business realignment charge included \$2.1 million for involuntary terminations.

The charge of \$51.2 million recorded in cost of sales during the first six months of 2007 for the 2007 business realignment initiatives related to the accelerated depreciation of fixed assets over a reduced estimated remaining useful life and costs related to inventory reductions. The \$6.3 million recorded in selling, marketing and administrative expenses related primarily to project administration. In determining the costs related to fixed asset impairments, fair value was estimated based on the expected sales proceeds. The employee separation costs

included \$23.7 million for involuntary terminations and \$29.2 million for charges relating to pension and other post-retirement benefits curtailments and special termination benefits.

A credit of \$1.6 million recorded in cost of sales for the 2005 business realignment initiatives related to higher than expected proceeds from the sale of equipment from the Las Piedras plant. The \$7.1 million charge associated with the 2005 business realignment initiatives related primarily to the U.S. VWRP, along with costs for streamlining the Company's international operations and facility rationalization relating to the closure of the Las Piedras plant. The business realignment charge included \$2.9 million for involuntary terminations. Charges (credits) associated with previous business realignment initiatives which began in 2003 and 2001 resulted from the finalization of the sale of certain properties, adjustments to liabilities which had previously been recorded, and the impact of the settlement as to several of the eight former employees who had filed a complaint alleging that the Company had discriminated against them on the basis of age in connection with the 2003 business realignment initiatives.

The July 1, 2007 liability balance relating to the 2007 business realignment initiatives was \$23.5 million for employee separation costs. The July 1, 2007 liability balance relating to the 2005 business realignment initiatives was \$8.7 million.

6. EARNINGS PER SHARE

In accordance with Statement of Financial Accounting Standards No. 128, *Earnings Per Share*, we compute Basic and Diluted Earnings Per Share based on the weighted-average number of shares of the Common Stock and the Class B Common Stock outstanding as follows:

	For the Three Months Ended		For the Six Months Ended	
	July 1, 2007	July 2, 2006	July 1, 2007	July 2, 2006
(in thousands except per share amounts)				
Net income	\$ 3,554	\$ 97,897	\$ 97,027	\$ 220,368
Weighted-average shares - Basic Common Stock	168,309	175,779		